Exploring the Determinants of High-Cost Mortgages to Homeowners in Low- and Moderate-Income Neighborhoods

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\(^1\)The views in this presentation do not reflect those of the Federal Reserve Board or its staff.
Description of Paper

Explore two mechanisms for differential mortgage pricing

1. Racial disparities
2. Mortgage brokers

Exploit household-level survey data of low- and moderate-income (LMI) households living in Detroit in 2005 and 2006 ($N = 938$)

Bottom line:

- Results are most consistent with lender-driven origins for differences in loan terms (with caveats)
  - Black homeowners pay 110 bp more than whites, 2x’s likely to have PP penalty, balloon payment
  - Results hold up even after controlling for broad range of demand-side characteristics
Detroit Area Household Financial Services (DAHFS) study

Cross-sectional SURVEY data on STOCK of LMI homeowners
- 45% are homeowners, $45K=median level of equity
- APR, balloon payments, up-front points/fees, “teaser” rates, prepayment penalties
- Use of mortgage broker
- Creditworthiness, default risk, attitudes about borrowing

Differs from ADMINISTRATIVE data on FLOW of mortgage applications (e.g. HMDA), originations, audit study
- Riskier borrowers are less likely to be observed in cross-section
- → Disparities estimated in cross-section understate differences in pricing at origination (under certain assumptions)
Characteristics of LMI Homeowners & Mortgages

Creditworthiness

- 15% have ever filed for bankruptcy, 6% have been denied a loan in 3 years prior to survey, 3% are behind on car loans, 1% have had bank account closed, < 1% pay less than minimum on credit card

(Ex post) Default risk

- 30% have delayed paying mortgage for a month or more
  - 40% because job loss, 24% because too many bills, 12% because emergencies, 8% cite unexpected medical expenses
  - Blacks more likely to delay payment

Mortgage pricing

- 29% pay points/fees, 23% have PPP, 11% have balloon payment
- 7.4% = mean APR (v. 5.5% prime offer rate)
Racial Disparities

Do observationally equivalent blacks and whites have mortgage with the same loan terms?

- 42% of homeowners are black

Controlling for creditworthiness, proxy for default risk, LTV, employment, household income, demographics

- Blacks are $> 2x$’s as likely to have prepayment penalties, balloon payments
- APR is 110 bp higher for blacks (consistent with Courchane (2007) and Avery et al. (2007))

Race-based differences exist after differential treatment during mortgage approval process

- Black households less likely to apply for mortgages and, conditional on applying, less likely to be approved (Charles and Hurst 2002)
Mortgage Broker

58% of homeowners use a mortgage broker

Controlling for creditworthiness, proxy for default risk, LTV, employment, household income, demographics, those who use a mortgage broker

- 60% (or 15 percentage points) more likely to pay points or fees
  - Average difference in fees is > $800
- Pay statistically similar interest rates, balloon payments

In spite of paying higher points/fees, borrowers do not seem to obtain lower interest rates
Race & Brokers

No difference in use of broker based on age, race, or income

- Suggests demand for brokers does not vary across demographic groups (in Detroit)

Unlikely for black/non-black differences in pricing to arise through broker channel

- Blacks using a mortgage broker face similar mortgage pricing as blacks *NOT* using broker
- Coefficient on black remains significant in regressions including the interaction of race and broker usage & coefficient on interaction is statistically insignificant
Conclusions

Differences in pricing persist among LMI households surveyed in Detroit in 2005/2006

- Black homeowners pay 110 bp more than whites, 2x’s likely to have PP penalty, balloon payment

Why?

- Underwriting technology has standardized mortgage origination process
- Cost of information has decreased (brokers, internet)
- Fair lending laws

Results are most consistent with lender-driven origins for differences in loan terms (with caveats)